

Independent Contractors and the IRS

An Honors Thesis (HONRS 499)

by

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The Internal Revenue Service has become increasingly concerned with the classification of individuals as independent contractors or employees. The IRS is now more aggressive in pursuing workers they believe to be misclassified. Taxpayers may still be eligible for relief but there must be evidence to back up the classification. This discussion includes the criteria used to determine worker's status. Also included are the benefits of contractor classification and the penalties for misclassification.

## Independent Contractors And The IRS

In recent years, employers have been faced with ever increasing labor costs. Labor costs include items such as employer tax liabilities, and fringe benefits, in addition to the set wage rate. The costs associated with maintaining a full time staff of employees have caused employers to look for a less expensive alternative.

One attractive alternative is independent contractor status. This classification lowers the employer's costs and enables the employer to benefit from the help of an extra worker without the additional employee costs. This can be very attractive to employers working in industries that are seasonal in nature or in a company undertaking a special project that is a short term undertaking. Firms can then benefit from professional expertise without the expense of carrying that payroll cost when the services are not needed.

Independent contractor status provides many tax advantages to both the employer and the employee. Congress estimates that the misclassification of workers causes the government to lose \$1.5 billion a year in tax revenues. (Weiss, 1990). Due to the large amounts at stake, the IRS has become more aggressive in its efforts to enforce the proper classification of workers.

### IRS 20 Point Test

The IRS and the courts normally consider twenty common law factors when determining whether a worker is an independent contractor or an employee. The factors

considered are as follows:

- 1) Instructions. An employee must follow the firm's instructions about how the job is to be completed.
- 2) Training. When training is provided, this shows that the firm wishes to control how the work is performed. This control indicates employment.
- 3) Integration. Employee services are integrated into the firm's operations and are important to the success or continuation of the business.
- 4) Personal service. Employees are required to personally perform work services.
- 5) Assistants. Independent contractors retain the right to hire their own assistants.
- 6) Continuity. A continuing working relationship usually indicates employment.
- 7) Work hours. Employers establish set working hours.
- 8) Full-time status. If the individual works so much for one employer that he is unable to pursue other employment, the individual will be considered an employee of that firm.
- 9) Firm's premises. If the work must be done at the firm's office, control is assumed and the worker will be considered an employee.
- 10) Order/sequence. Employment is indicated if a firm establishes a set order to be followed in completing a job or retains the right to do so.
- 11) Reports. Employees may be required to submit regular oral or written reports.
- 12) Payments. Independents are usually paid by the job or on commission, rather than by the hour, week or month.
- 13) Expenses. Independent contractors are responsible for their own business expenses. An employee's expenses are covered by the employer.
- 14) Tools and supplies. Employers furnish the needed tools, supplies, materials and other equipment.
- 15) Investment. Independent contractors generally have funds invested in equipment and facilities.

- 16) Profit/loss. Due to the independent's investment and responsibility to cover business expenses, the individual is left open to the possibility of loss or the opportunity to make a profit.
- 17) Number of firms. An individual working for only one firm is considered an employee of that firm.
- 18) Advertising. Independent contractors offer their services to the general public.
- 19) Right to fire. An independent contractor usually cannot be fired unless contract terms are not met.
- 20) Right to quit. An independent contractor is legally responsible to complete the contracted job.

#### Statutory Classification

In some cases an individual's status has been defined in the Internal Revenue Code. Under Sec. 3401 any officer, employee or elected official of the U.S., a state or any agency of either will be considered an employee. (Sumutka, 1989).

Section 3121(d) defines employee to also include officers of a corporation, common law employees and certain workers performing personal services. This would include agent or commission drivers, full-time life insurance salesmen, home workers performing work to employer specifications and full-time traveling salesmen.

Some individuals may be eligible for statutory classification as independent contractors. These would include professionals who offer their services to the general public, a director of a corporation, qualified real estate agents and direct sellers.

To be a qualified real estate agent the individual must be licensed. A direct seller sells consumer products to a

buyer for resale other than in a retail establishment.

Examples of direct sellers are Avon or Tupperware salespersons. (Sumutka, 1989).

In both cases of a real estate agent or direct seller, income must be based on sales. A contract also should be written in which it is agreed that the worker will not be treated as an employee for federal tax purposes.

#### Benefits of Independent Contractor Classification

For an employer it is often cheaper to use an independent contractor rather than hire an employee. Employers save on payroll taxes such as social security and employment taxes. They also are not required to offer fringe benefit plans and independent contractors do not qualify for vacation or sick pay.

There are advantages to the individual worker as well. Almost all business expenses can be deducted. An independent contractor is also eligible for more tax-deferred savings through a Keogh plan than regular corporate employees. (Weiss, 1991).

The contractor may also provide generous tax-favored fringe benefits programs. These programs can provide tax savings even if the only employee is the individual contractor. This enables the contractor to provide benefits that would be too expensive for an employer to provide for a large number of workers.

#### Safe Haven Provisions

Under Section 530 of the Revenue Act of 1978, the IRS

will allow independent contractor classification if for purposes of employment taxes an individual was not treated as an employee for any period. But there are three conditions that must be met. These include reasonable basis, consistent treatment and all filing requirements must be met.

Reasonable basis includes judicial precedent or published rulings, a past IRS audit or industry practice. If an employer does not meet any of the specific safe harbor exemptions the company may still be able to qualify by showing other reasonable basis.

When the IRS has conducted a past audit and the tax treatment of workers was not questioned, the employer can rely upon this audit as reasonable basis. The IRS has strictly interpreted the industry practice safe haven. To qualify for relief nearly all of the employers in an industry segment must treat that particular type of worker as an independent contractor. (Frank, 1991).

Revisions were made to Section 530 by the Tax Reform Act of 1986. These changes were made to counteract the competitive advantage independent contractors have over regular employees. Section 530 no longer applies to certain technical service personnel, including engineers, designers and computer programmers. To qualify for independent contractor status, such workers must pass the common law test.

#### Consistent Treatment

In addition to having reasonable basis, the employer

must demonstrate consistent treatment of workers.

To qualify the employer cannot treat the worker as an employee for any period after December 31, 1977. Treatment as an employee would include withholding employment taxes or filing an employment tax return. (Oden, 1991).

Section 530(a)(3) requires that any individual holding a substantially similar position must also be treated as a non-employee.

The third condition for Section 530 protection is the filing of all required information returns. Employers are required to file a Form 1099-Misc reporting any amounts over \$600 paid in a calendar year to an independent contractor. In accordance with the consistent treatment requirement, a Form W-2 should not have been filed for any person holding a substantially similar position.

#### Misclassification Penalties

Penalties can be severe if the IRS determines that a worker has been misclassified. In general, assessments are subject to a three year statute of limitations. But if no employment tax return was filed or there is evidence of fraud or a willful attempt to evade taxes, there is no statute of limitations. (Sumutka, 1989).

The employer will be held responsible for back taxes such as social security and unemployment taxes. If the business is unable to pay these taxes the IRS may attempt to find the person responsible for the misclassification. This individual can then be held personally liable for the taxes



owed.

If it is proven that the misclassification was intentional to avoid taxes, the employer will be responsible for both the employer and employee share of back taxes. Additional penalties will also be imposed for fraud, willful failure to collect employment taxes and failure to make deposits. Even if the error is unintentional the party could be fined for negligence. In either case, interest will be added to the amount owed. The IRS may agree to waive penalties if the employer agrees to correctly classify workers in the future.

The independent contractor could be disallowed many deductions if the IRS determines he was actually an employee. If self-employment taxes have not been paid, the employee must also pay his share of FIT and FICA tax in addition to interest and possible penalties.

When self-employment tax has been paid this amount is generally greater than the employee's share of FICA. The employee will receive a refund of the excess. The employee may also be able to go back and make a claim for employee benefits the individual would have received while classified as an employee.

#### Increased Enforcement Efforts

Independent contractor status is now a high exposure audit area. During 1991 the IRS increased payroll audits by fifty percent. The IRS commissioner has also suggested that Congress consider repealing Section 530.

The IRS uses snitch sheets to locate companies that may be incorrectly classifying workers. These sheets allow employees or other companies to anonymously report companies that use independent contractors.

A review of a company's year-end distribution of Form 1099s is now included as a part of every standard business audit. (Miller, 1991).

A matching program automatically matches 1099 wage earners with their companies. Particular attention is paid to individuals who earn more than \$10,000 from one source.

#### Preparation

The most important defense against IRS reclassification is preparation. A firm should have evidence available to back up independent contractor status. A written agreement between the company and the individual may prove helpful as a record of the working relationship. This agreement should emphasize the factors that indicate independent contractor status. To protect the firm, the agreement should state that the independent contractor will accept responsibility for any federal, state, and local taxes due on income generated from this engagement. The contractor should also agree to reimburse the employer for any additional taxes due if the IRS determines the individual should have been classified as an employee.

If challenged, it is possible to fight the IRS and prove that a firm's workers are correctly classified as independent contractors. These battles may prove to be long and costly

and many small businesses would have a hard time withstanding the financial burdens long enough to prove their case.

An example of a company that was able to win this fight is Critical Care Registered Nursing, Inc. Critical Care was audited for the years 1982 and 1983 and the IRS concluded through the use of the twenty common law factors that the nurses were employees instead of independent contractors.

After seven years of initial proceedings, Critical Care went to court where the firm proved to a jury that the nurses qualified as independent contractors. The IRS asked for judgment notwithstanding the verdict, but the request was denied. (68 AFTR 2d 91-5716).

The firm's attorney concentrated on showing that the nurses qualified as contractors under the twenty point test. This was demonstrated by the lack of control and supervision Critical Care had over the nurses. In addition, the nurses were not integrated into the daily operation of the business.

The judge stressed the fact that if the firm had reasonable basis, the company was entitled to relief under the Section 530. The jury held for the defendant since this classification was a long-standing recognized practice of a significant segment of the industry.

Independent contractor status can benefit both the individual and the hiring firm. A firm should not shy away from the legitimate use of independent contractors because of feared IRS ramifications. Instead, the company must realize that this is a high exposure audit area that is being

aggressively pursued by the Internal Revenue Service.

To protect their interests management must be able to provide substantiating evidence to back up the classification. If the company has this evidence, the increase in IRS interest in this area should be no cause for alarm.

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